Minutes of the Meeting of the
Treasury Borrowing Advisory Committee
of the Securities Industry and Financial Markets Association
July 31, 2007

The Committee convened in closed session at the Hay-Adams Hotel at 11:30 a.m. All Committee members except Mark Werner were present. Under Secretary Robert Steel, Assistant Secretary Anthony Ryan, Deputy Assistant Secretary Matthew Abbott, and Office of Debt Management Director Karthik Ramanathan welcomed the Committee and gave them the charge.

The Committee addressed the first item in the Committee charge (attached) regarding debt issuance in light of intermediate and longer-term fiscal trends. Deputy Assistant Secretary Abbott presented a series of charts related to fiscal trends, and noted that current trends, including better revenue growth and slower growth of outlays, remain in place. Moreover, between February and July, OMB estimates for the 2007 deficit have dropped by almost $40 billion. In addition, the charts showed OMB's projections of an improving fiscal outlook over the next five years with a balanced budget by 2012. As a result of this improving fiscal background, marketable debt issuance – both bill issuance and coupon issuance – continue to decline in size. Deputy Assistant Secretary Abbott noted that while Treasury currently feels content with its schedule, preserving its flexibility to address a range of fiscal outcomes was important.

The Committee began by noting that despite a lack of tightness in financing markets, the benchmark issue sizes were close to the lower limits of liquidity thresholds. One member noted that the value of the financing markets as an indicator of cash-market supply shortages was somewhat muted by the perception that regulators were monitoring repurchase market activity more closely. Another member noted that Treasury may have some additional room to reduce coupon sizes at the front end of the curve including bills and the 2-year note without impacting liquidity.

Members generally agreed that given the recent discontinuance of the 3-year note, Treasury was well positioned for a near-term deficit surprise, either to the upside or the downside. One member noted that Treasury's desire to maintain flexibility regarding debt issuance was well understood by market participants. Another member suggested that Treasury should publicly reiterate its strategy of maintaining flexibility because of the uncertainty that it faces, highlighting potential fiscal outcomes associated with different deficit forecasts. This same member suggested that Treasury conditionally describe the implications for possible changes to the current issuance patterns under these various scenarios.

Several Committee members noted that current trends in outlays may quickly reverse in the coming year, and that Treasury should be prepared for higher borrowing needs. Another member noted that a sudden shift in the economy could impact revenues – particularly corporate profits – disproportionately.

While members felt that Treasury was well positioned for any upside surprise in deficits, they acknowledged that more difficult decisions would need to be made with declining deficits. Members discussed options for dealing with declining deficits, noting that any fiscal improvement was likely to be a short-to intermediate term phenomena, and thus should be addressed by changes in short to intermediate term financing. One member commented that the 5- to 10-year nominal sector of the curve was used extensively in financial markets and that Treasury should exercise caution about changing issuance in that sector. Another member noted that there was increasing demand for longer duration assets from pension funds, and that such demand was expected to grow.

With declining deficits over the short to intermediate term, members suggested several potential responses, including the elimination of the 5-year TIPS, the reintroduction of buybacks,, and the elimination of the 10-year note reopening. With regard to the 5-year TIPS, members argued that it was not an effective financing vehicle because it really did not have a consistent real money investor base. One member argued that the 5-year TIPS, or even a 3-year TIPS, could be brought back at a later date if additional financing needs developed. Another member noted that eliminating the 5-year TIPS would not reduce financing very much since it was such a small issue; nonetheless, its demand base appeared limited. Some members urged caution regarding changing the 10-year reopening given its importance as a benchmark

Regular buybacks were also seen as a way of addressing lower borrowing needs while maintaining liquid benchmark issuance. One member was cautious regarding the actual implementation and operations surrounding buybacks. Another member suggested that buybacks, if implemented, should target the front or intermediate sector of the curve, not just the back end of the curve, given the long-term fiscal outlook. Another member stated that Treasury should probably avoid repurchasing long-term debt. Several members noted that given volatility in cash balances, buybacks could be an effective cash and debt management tool.

Another member noted that given the maturity profile over the next three years, paying down maturing debt in the short end of the curve could be beneficial, particularly given recent swings in cash balances. Members generally agreed that Treasury would need to approach the market in a transparent manner similar to its auctions if it were to consider this alternative.

The Committee did not reach a consensus recommendation on what tool to use next to address substantial reductions in borrowing needs, noting that such a decision would be premature. If, at some future point, it became clear that Treasury needed to act to reduce financing, market conditions would have to be assessed before an appropriate decision could be made.

The Committee then addressed the second item in the charge regarding alternative asset management vehicles. In particular, the Committee was asked for its thoughts on the benefits of and challenges posed by such entities for global capital markets, and specifically, the US Treasury market, given that a number of sovereign wealth funds have been initiated to manage foreign exchange assets as foreign exchange reserves have grown over the past few years. A Committee member was asked to address this item.

The Committee member began by noting the presence of sovereign wealth funds (SWFs) in the market had little impact on the Treasury market. The member stated that purchases of Treasuries by SWFs as a percent of net Treasury issuance has been constant, and that as long as reserves were growing, there would be minimal effect on demand for Treasuries by these entities.

The member also felt that SWFs would have little impact on global capital markets. The member felt that the main issue related to the presence of SWFs in markets was the lack of transparency. Because SWFs can have different trading styles (e.g., momentum investing vs. value investing), their activity has the potential to dampen or exacerbate market volatility. However, the Committee member noted that other major classes of investors, such as real money accounts, hedge funds, and pension funds, had substantially more assets under management and had adapted to the marketplace. The Committee member stated that open investment was key to maintaining efficient markets, and that SWF's added to the overall efficiency of capital markets.

A discussion followed the presentation. Members pointed out that SWFs have higher risk appetites than traditional government reserve managers and, as such, would probably seek out dollar-denominated assets with greater returns than Treasuries, including engaging in direct investment or purchasing stakes in private equity funds. One member stated that Treasury purchases could decline in the future as SWF's reallocate assets. Several members discounted that view and suggested that SWFs should be regarded as managing the long-term financial assets of sovereign entities, and that there would always be a demand from reserve managers for the credit-risk-free liquidity of Treasury securities.

Another member, noting that many SWFs are operating on behalf of natural-resource rich sovereigns, suggested that the motivation for many SWFs is as much related to asset diversification and risk reduction as it is to maximizing returns. This member stated that SWFs are seeking to substitute physical wealth for financial wealth; moreover, the desire for such diversification was a natural and healthy investment process and that other nations should be very careful about reacting via regulations that would impede this natural process. Creating barriers to investment thus could create pricing distortions, may not work given the fungibility of investments, and may impede transparency. Instead, the appropriate policy reaction should be to encourage SWF to be as transparent as possible with regard to 1) the governance of the fund, 2) its investment process, and 3) its risk management.

Several members agreed with this perspective, stating that SWFs should not be required to be fully transparent, and even if they were with a party such as the IMF or World Bank, that such information would be dated or lack usefulness.

Other members agreed that policy makers should not overreact to SWFs. One member suggested that SWFs were just another “actor” on the stage of financial markets, and global markets would adjust to their presence. The Committee strongly agreed that the United States should maintain an open investment policy, and defend that policy aggressively.

Finally, the Committee was asked about the costs of inaction regarding entitlement reform, and in particular, the potential implications for Treasury debt issuance, interest costs, and overall market dynamics.

A Committee member presented a series of slides in which three scenarios were modeled. (See attached.) These scenarios were based on assumptions by the Congressional Budget Office. The conclusions from the slides were that, even under the most optimistic scenario, the current situation regarding entitlements was financially unsustainable. In particular, the presenting member noted that the funding needs for the government would vastly exceed available capital if entitlement reform was not addressed.

The static model used in this exercise was utilized CBO assumptions, with an assumption that interest rates were fixed over the analysis horizon at current levels. The member acknowledged that if interest rates were allowed to fluctuate, the impact would be even greater. Issuance volumes and DV01 risk as were used as metrics to assess sustainability of the current entitlement programs. For example, the Committee member cited the potential monthly 2-year size in 2050 of nearly $380 billion in the most optimistic scenario, and a potential monthly 2-year size in 2050 of nearly $1.9 trillion billion in the pessimistic scenario.

The presenting member indicated that the model showed these metrics reaching unsustainable levels in the near future, and that action was needed now to avoid future market dislocations.

Committee members agreed that action was necessary now regarding entitlement reform. Several members acknowledged that market participants could not readily discount the potential effects to the market of such massive potential borrowing needs, and that the presentation at least gave some perspective of the enormity of the issue. Other members suggested that rising interest rates be incorporated into the model to create a more realistic – though more negative – perspective. Overall, Committee members agreed that policy makers – and the market - need to focus on this looming issue.

The Committee then reviewed the financing for the remainder of the July through September quarter and the October through December quarter.

The meeting adjourned at 12:33 p.m.

The Committee reconvened at the Hay-Adams Hotel at 6:00 p.m. All the Committee members except Mark Werner were present. The Chairman presented the Committee report to Under Secretary Steel. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 6:15 p.m.

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July 31, 2007

Certified by:

Tom Maheras, Chairman
Treasury Borrowing Advisory Committee
Of The Securities Industry and Financial Markets Association
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Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – July 31, 2007

Fiscal Outlook

In light of intermediate and longer-term fiscal trends as well as recent economic and market conditions, what advice would the Committee give in terms of Treasury's debt issuance?

Alternative Asset Management Vehicles

As foreign exchange reserves have grown over the past few years, a number of sovereign wealth funds have been initiated to manage foreign exchange assets. What are the Committee's thoughts on the benefits of and challenges posed by such entities for global capital markets, and specifically, the US Treasury market?

Entitlement Program Reform

Treasury seeks the Committee's perspectives on the costs of inaction regarding entitlement reform. What are the potential implications for Treasury debt issuance, interest costs, and overall market dynamics?

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes and bonds to refund approximately $62.6 billion of privately held securities maturing on August 15, 2007.

- The composition of Treasury marketable financing for the remainder of the July-September quarter, including cash management bills.

- The composition of Treasury marketable financing for the October-December quarter.